MILLENNIUM CHALLENGE CORPORATION
UNITED STATES OF AMERICA

MCC's Mission and Analytic Approaches

Topic Note for the March 2021 Economic Advisory Council Meeting

Since its establishment in 2004, MCC has pioneered a distinct approach to foreign assistance and development effectiveness that make it stand out among aid agencies. Providing close to $1 billion annually to two dozen countries, MCC targets large-scale grant funding with partner countries deemed to be well-governed, committed to democratic principles, and invested in their citizens. Independent policy indicators guide MCC's apolitical country selection process. And rigorous, well-funded monitoring and evaluation processes reflect the agency's commitment to results, learning and accountability. MCC has also adopted a strong, collaborative approach to partner country ownership and program oversight alongside a strong emphasis on transparency and public consultation.

Early programs, however, did suffer from over-ambition and a tendency to address too many issues. As a result of inadequate prioritization and focus, programs grew unwieldy and strained the capacity of MCC's partner countries. To correct this and focus its efforts, a decade ago MCC adopted a growth diagnostics framework to identify the most "binding constraints to growth." This approach, developed at Harvard's Center for International Development (CID), conferred greater analytical heft to the agency's founding objective of "Poverty Reduction through Growth."

Since then, MCC's evidence-based approach has evolved beyond growth diagnostics. It has introduced "root cause analysis" to better understand the reasons and context for the persistence of the identified constraints and is beginning to deploy new analytical tools to capture the interaction of labor markets, fiscal incidence, and gender disparities with a country's growth constraints. MCC also conducts rigorous cost-benefit analysis on all candidate investment projects. Only projects estimated *ex ante* to generate a 10-percent economic rate of return can meet approval. This strong commitment to economic analysis and justification has become a hallmark of MCC's practice.

MCC operates independently of its much larger sister agencies U.S. Agency for International Development (USAID) and the newly constituted U.S. International Development Finance Corporation (DFC, formerly OPIC). Interactions among them are sometimes collaborative, but the agencies are not closely integrated or coordinated.

MCC Challenges for 2021 and Beyond

The MCC model has served the agency well, sustained by strong bipartisan support in Congress and earning accolades across the development community. But in light of economic shocks, accelerating climate threats, and a rapidly shifting digital technology landscape, an opportunity arises to review MCC from a fresh perspective and consider ways to strengthen the agency's development impact and help achieve USG priorities. The overarching question to EAC members is: *What are development's biggest challenges, and how can MCC analytics and operations ideally help to meet them?*

Three specific dimensions of MCC engagement deserve consideration:

1. The conditions and channels for development assistance;
2. MCC's narrowing scope for country partnerships, and
3. Sustainability and resilience.

1. Conditions and channels for development assistance

MCC operations conform with widely accepted hallmarks of high-quality aid, for example the QuODA index developed at the Center for Global Development. Engagement hinges on partner countries' own development and governance indicators. Investments are designed with a view towards growth impacts over the medium term coupled with technical assistance to build partner country capacities. Decisions and activities are transparent, and aid is not tied to US-origin suppliers. MCC bears most all internal compliance costs.

- Twenty years after the literature boom on aid quality, have new lessons and insights emerged on aid effectiveness? Are there elements of the "good donors" rubric that MCC should give greater attention to?
- Should MCC continue to heavily weight the role of governance?
- Does the private sector's role deserve greater attention and emphasis?
- How critical is social inclusion to sustainable growth?
- Does MCC's pure grant financing, distinct from the Multilateral Development Banks (MDBs), open avenues of influence (e.g., in countries with debt distress) that could be more fully used, for example to leverage private infrastructure investment or climate change mitigation?

MCC's comparative depth in infrastructure development, alongside its growth diagnostics approach, has traditionally led to large projects designed to promote country-wide private investment and growth, e.g., power, water, sanitation, and hygiene (WASH), and roads. While a focus on growth remains foundational, attention has recently expanded to include qualitative aspects of growth, including distributional outcomes, employment generation, and risks related to climate change. It is also argued that the needs of specific disadvantaged groups and localities suggest a more granular, community-based approach that achieves the goals of widening participation, listening to more voices, and more pro-poor growth.

- What are the merits of refocusing support away from national growth toward a more community-based approach? Is this likely to be more equitable and sustain poverty reduction? What metrics might drive project prioritization?
- Alternatively, should MCC build on its current experience in infrastructure and constraints to growth? Might the objective of sustained poverty reduction be better served through greater specialization in the provision of core infrastructure services, such as power, transport, WASH, supplemented with technical support or partnerships for establishing the policy and institutional conditions needed to sustain service delivery?

MCC's unique analytical approach and its grant support for large public sector projects distinguishes it from sister aid agencies in the US government. For example, the DFC facilitates development-oriented private investments through capital, guarantees, and other instruments. USAID advances US foreign policy and strategic interests across a range of areas, including democracy and governance, global health, disaster relief, and others, largely through non-governmental channels.

- Notwithstanding the advantages of its distinctive niche, should MCC seek greater collaboration with other US government aid agencies? How could interagency collaboration strengthen foreign assistance development impact and outcomes? Are particular areas now ripe for such efforts, e.g., public goods associated with digital technologies, climate change, disease outbreaks?
- Given these major challenges in the decades ahead (climate change, disruptive technologies, etc.) what partnerships and instruments hold the greatest opportunity? What risks would counsel caution?

2. MCC's Narrowing Scope for Engagement

One consequence of MCC's approach to country selection is a dwindling number of potential partner countries. (See Box 1 below for details). In the most recent fiscal year, only 78 countries met MCC's income requirements, and of those, only 25 passed the MCC scorecard to be then considered for compact partnership. Many are concentrated in sub-Saharan Africa, and most already have extant or historic partnerships with MCC. Of Sub-Saharan Africa's 49 countries, only 15 pass the scorecard. This represents about one-fifth of the sub-continent's population and not even a quarter of its poor. As a result, MCC's rules for engagement filter out a large fraction of the very population that MCC targets. [1]

- Should MCC consider raising its country income criteria?
- Are non-income or sub-national indicators of economic well-being, e.g., access to health services, food security, access to finance, and measures of vulnerability, useful criteria for partner selection?
- Should MCC consider pursuing country partnerships beyond two sequential compacts?

3. Sustainability and resilience

MCC vets its programs on the basis of ensuring sustainability through design elements and rigorous cost-benefit analysis. However, aspects of its model can confound this objective.

- MCC concludes compact funding after five years, a short period for many substantive

interventions. It also leaves little room for slippage or interruption.
- MCC applies a 10% discount rate to benefits over time, biasing the agency against projects with long time horizons, such as climate change-related mitigation and adaptation or investments in early childhood development. Benefits over MCC's 20-year cost-benefit analysis (CBA) horizon may omit or underweight long-run benefits.
- MCC limits itself to two 5-year programs and does not address the same constraint twice (though not a statutory requirement).
- Policy and institutional reform is viewed by many as central to sustainability but few MCC compacts address this beyond providing technical assistance.

Moreover, MCC's long running use of CID's growth diagnostics methodology, a data-driven heuristic for identifying binding constraints to growth, relies on strong neoclassical assumptions and emphasis on growth. Comparatively less attention focuses on the threat*s* to growth from natural disasters, disease, climate change, global economic volatility, or disruptive technologies. "Stress tests" on different dimensions of a country's economy may reveal vulnerabilities to potentially large, unpredictable shocks to well-being.

- Should MCC analytics and its consequent investments give greater weight to considering growth that is *resilient* to such threats?
- Would refocusing on resilience meaningfully enhance MCC's ability to support medium and long-term priorities facing poor countries?

Box 1: MCC Country Selection

MCC begins its country selection process by compiling a list of candidate countries designated by the World Bank to be low income (<$1,035) or lower middle income ($1,036-$4,045). Subsequently, each candidate country is evaluated on a "scorecard" of 20 indicators spanning three broad categories: economic freedom, investment in people, and ruling justly. MCC's authorizing law established each criterion against which a country is evaluated, though the specific data used are determined by MCC. MCC does not calculate these indicators itself; rather it relies on data produced by outside, independent parties, including the World Bank, Freedom House, Reporters Without Borders, and UNESCO. Of the 20 indicators, a country must pass 10, including one indicator under each category. Passing means performing better than the median score in a country's income group or satisfying some absolute threshold, e.g., inflation must not exceed 15 percent. In addition to passing at least 10 indicators overall, to "pass" the scorecard a country must-pass (1) the control of corruption indicator; and (2) also pass either the political rights or the civil liberties indicator. For each candidate country, MCC collects and processes the data across all 20 indicators. Countries are expected to pass the scorecard to be considered by MCC's Board of Directors for Compact selection at its December meeting each year. In December 2020, the MCC Board selected Sierra Leone for a Compact Program and Kiribati for a Threshold Program. MCC currently limits its country partnerships to two sequential bilateral compacts.

Endnotes

1. The COVID-19 economic shock will likely raise the number of income-qualifying countries in the short term.